LAW SUMMARY
NONRESIDENT or PART-YEAR RESIDENT TAX LIABILITY
2001 and PRIOR YEARS

California law provides the specific method to be used to determine the tax liability of a nonresident or part-year resident taxpayer.

1. California law.

California Revenue and Taxation Code section 17041, subdivision (b), provides that for each taxable year there shall be imposed upon the entire taxable income of every nonresident or part-year resident a tax on the income received from sources in California.

The tax is equal to the tax computed as if the nonresident or part-year resident were a full year resident of California multiplied by the ratio of California source adjusted gross income (AGI) to total AGI from California and non-California sources.

California's method of computing the tax liability of a nonresident or part-year resident taxpayer <u>does not</u> impose a tax on the taxpayer's income from sources outside of California (non-California source income). (See *Appeal of Dennis L. Boone*, 93-SBE-015, October 28, 1993.)

2. Computation of tax.

The method of computing a nonresident or part-year resident's California tax liability uses the following six steps:

<u>STEP 1:</u> The taxpayer determines his total income from all sources. Total income includes income from sources within California and outside of California including military income and foreign earned income.

<u>STEP 2:</u> The taxpayer determines his or her total AGI from all sources. NOTE: to determine total AGI **do not deduct** income earned while a nonresident of California, or military income, or foreign earned income.

<u>STEP 3:</u> The nonresident or part-year resident taxpayer computes the tax liability on his or her total taxable income as if the taxpayer had been a resident of California the entire year.

Total AGI from all sources (STEP 2)
less <u>the standard (itemized) deduction</u>
Total taxable income

Then, compute the tax on the total taxable income.

<u>STEP 4:</u> The taxpayer identifies his or her California source AGI. This is any income from a source within the State of California and income from non-California sources earned while a resident of California.

<u>STEP 5:</u> Divide the amount of California AGI identified in STEP 4 by the amount of total AGI identified in STEP 2.

$$\frac{\text{California AGI in STEP 4}}{\text{Total AGI in STEP 2}} = \text{Percentage}$$

<u>STEP 6:</u> The amount of tax determined in STEP 3 is multiplied by the percentage determined in STEP 5. This is the taxpayer's California tax liability.

3. The California method does not tax non-California source income.

The State Board of Equalization (Board) has consistently held that the use of the California method of computing a nonresident's tax is not the same as a tax on non-California source income.

The Board considered this issue in the *Appeal of Louis N. Million*, 87-SBE-036, May 7, 1987, where the taxpayer argued that he had only lived in California two or three months and that California was taxing both his California and non-California income. The Board held that the taxpayer had misconstrued the action of the Franchise Tax Board (FTB). The Board stated that under the law, the FTB was not taxing the taxpayer's non-California source income, but had merely used the taxpayer's total income from all sources to determine the rate of tax and then used the applicable ratio (or percentage) to determine the California tax. (See *Appeal of Dennis L. Boone*, 93-SBE-015, October 28, 1993.)

Consequently, the FTB's calculations which included the taxpayer's California and non-California source income did not result in a tax being assessed on the taxpayer's (nonresident) income from sources outside of California.

4. Military income and the California method.

In the *Appeal of Dennis L. Boone*, 93-SBE-015, October 28, 1993, the taxpayer argued that the FTB's use of his nonresident military income in determining his tax allowed California to wrongfully tax military income earned by a nonresident. The Board determined that Revenue and Taxation Code section 17041 was the "precise method" to be used to calculate the taxpayer's California tax liability, stating:

> ". . . this result is supported by the decision in *United States v. Kansas* [citation], wherein the court held that a Kansas statute, which was similar to section 17041, subdivision (b), did not violate the Supremacy Clause of the United States Constitution by infringing upon the purposes of the Soldiers' and Sailors' Civil Relief Act of 1940 by taxing, either directly or indirectly, nonresident military income."

Accordingly, California can use the taxpayer's military income to compute the percentage (see section 2, Computation of tax) used to determine the final tax liability. Therefore, Revenue and Taxation Code section 17041, subdivision (b), provides a method of determining a taxpayer's tax liability which does not impose a tax on his or her military income.

5. It does not violate the Constitution for California to use income from outside of California to determine a taxpayer's California tax liability.

It has long been an established rule that states may use nontaxable out-of-state assets as the measure of the state tax imposed. (See *Great Atlantic & Pacific Tea Co. v. Grosjean* (1937) 301 U.S. 412 [81 L.Ed. 1193]; *Maxwell v. Bugbee* (1919) 250 U.S. 525 [63 L.Ed. 1124].) Therefore, it is permissible for California to use income from outside of the state to calculate a taxpayer's California tax liability.

6. It is not unfair to use the nonresident or part-year resident's non-California source income to determine their tax rate, because California uses a progressive rate system.

California's progressive rate structure is based on the concept of "ability to pay." Individuals with higher income pay tax at a higher rate than low-income individuals. The fundamental fairness of such a rate structure was recently explained in *Brady v. New York* (1992) 80 N.Y.2d 596, 605 [607 N.E.2d 1060], certiorari denied (1993) 509 U.S. 905 [125 L.Ed.2d 692; 113 S.Ct. 2998]. The Court reasoned that similarly situated taxpayers were those with the same total income. For example, a nonresident earning $20,000 in New York, but with reported total income of $100,000, should be taxed at the same tax rate as a resident with an income of $100,000. In effect, the $20,000 will be taxed using a higher tax rate. In *Brady*, not using the taxpayer's total income to determine his rate of tax would have unfairly benefited him when compared with other New York taxpayers. NOTE: This is the same as STEP 1 in California's computation of the taxpayer's tax liability.

The *Brady* Court concluded that the taxpayer's real quarrel was with the graduated tax. The system of progressive taxation apportions the tax burden based on ability to pay. Because higher income taxpayers can pay more, they are therefore taxed at a higher rate than lower income taxpayers. (Also, see *United States v. State of Kansas* (10th Cir. 1987) 810 F.2d 935, affirming (D.Kan. 1984) 580 F.Supp. 512, 515; *Appeal of Dennis L. Boone*, 93-SBE-015, October 28, 1993.)

7. Change of filing status to married filing separate after a joint return has been filed.

In general, California law requires taxpayers who file joint federal returns to also file joint California returns for the same taxable year. (Revenue and Taxation Code section 18521.)

After filing a joint return, taxpayers cannot elect to file separately after the due date for filing the tax return has passed. (Revenue and Taxation Code section 18521(d).) Taxpayers filing a joint return have created joint and several liability, and FTB can proceed against either or both for the entire amount of a deficiency. (Revenue and Taxation Code section 19006(b); *Appeal of Bennie A. Jefferson*, 79-SBE-104, June 28, 1979.)

In addition, the federal and California instruction pamphlets advise taxpayers to calculate their tax liability using the married filing separately **and** the married filing jointly statuses to determine which method will produce the least amount of tax. Because California law does not allow a separate return to be made by either spouse after the due date for filing their tax return for that taxable year has passed, careful thought should be given the status chosen prior to filing the return. (Revenue and Taxation Code sections 18521(d) and 18566.)

8. A husband and wife must use the same filing status on their California return as they used on their federal return.

The general rule applies to all taxpayers unless they qualify for the exceptions listed in either section 9 or 10 of this law summary. (Revenue and Taxation Code section 18521(a)(1).)

Except for taxpayers described in Section 11 (below) for any taxable year with respect to which a joint return has been filed, a separate return shall not be made by either spouse after the due date of the return has passed. (Revenue and Taxation Code section 18521(d) and former section 18521(e).)

9. Even if husband and wife file a joint return with the IRS, they may file separate state returns if one spouse is in the military.

The pamphlets for California forms 540 and 540A contain instructions on how taxpayers are to determine their filing status. The instructions clearly indicate that if during the taxable year either spouse was an active member of the United States military, the couple <u>may</u> file either separate returns or a joint return. (Revenue and Taxation Code section 18521(c)(1).)

If the couple elects to file a joint return and one spouse was a nonresident during the taxable year, the couple <u>must</u> use the form 540NR, California nonresident or part-year resident income tax return.

Also, see limited exception in Section 11 below.

10. Even if husband and wife file a joint return with the IRS, they may file separate state returns if one spouse was a nonresident the entire year and had <u>no</u> California source income. (Revenue and Taxation Code section 18521(c)(2).)

However, the marital property interest in personal property is determined under the laws of the acquiring spouse's domicile. (*Schecter v. Superior Court* (1957) 49 Cal.2d 3, 10; *Rozan v. Rozan* (1957) 49 Cal.2d 322, 326.)

Consequently, under California's community property laws one-half of the resident spouse's salary or income from an asset of the community may be considered to be California source income of the nonresident spouse. (*United States v. Malcolm* (1931) 282 U.S. 792; *United States v. Mitchell* (1971) 403 U.S. 190; *Appeal of Idella I. Browne*, 75-SBE-019, March 18, 1975.) If this situation exists, the couple does not meet the requirements of the exception, because the nonresident spouse has California source income.

If the couple does not meet the requirements of the exception and filed a joint federal return, a joint California return must be filed. Consequently, the couple <u>must</u> have filed separate federal returns in order to file separate California returns to avoid the computations detailed in section 2 of this law summary.

Also, see limited exception in Section 11 below.

11. For tax years beginning on or after January 1, 2000, a limited exception to the rule indicated in Section 8 applies.

Revenue and Taxation Code section 18521(d) provides a limited exception to the general rule that taxpayers cannot change their filing status from joint to separate after the due date of the return has passed. Taxpayers are allowed to change their filing status from joint to separate if one taxpayer was an active member of the armed forces or any auxiliary branch thereof, or one taxpayer was a nonresident for the entire taxable year with no California source income. The amended returns changing the joint filing status to the separate filing status must be filed within four years of the due date of the return. This limited exception applies to tax years beginning on or after January 1, 2000. (Revenue and Taxation Code sections 18415(a) and 18521(d) as amended by California AB 1635 (Stats. 1999, Ch. 605).)